

ANALYSIS OF AMENDED BILLAuthor: Scott Analyst: Jeff Garnier Bill Number: SB 1805Related Bills: See Legislative History Telephone: 845-5322 Amended Date: June 17, 2002Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Federal Conformity – AB 1122 Clean-Up

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED

X May 23, 2002 STILL APPLIES.

OTHER - See comments below.

SUMMARY

This bill would:

1. Adopt the federal employer-provided adoption assistance income exclusion.
2. Extend the time a "financially disabled" taxpayer has to file for an income tax refund.
3. Adopt certain federal scholarship and fellowship income exclusions (page 3).
4. Correct AB 1122's (Stats. 2002, Ch. 35) inadvertent failure to conform to installment sale pledge rules (page 4).
5. Make several technical non-substantive corrections to AB 1122 (page 5).
6. Permit a 100% shareholder of an S corporation to file a group return (page 5).

SUMMARY OF AMENDMENTS

The June 17, 2002, amendments added items 3 through 6 listed above and are discussed in this analysis.

Items 1 and 2 were discussed in the department's bill analysis of the bill as amended May 13, 2002, and are not mentioned further in this analysis.

Board Position:

<u>X</u> S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ PENDING

Department Director

Date

Gerald H. Goldberg

7/26/02

PURPOSE OF THE BILL

According to the author's staff, the intent of the bill is to simplify California income tax law by providing taxpayers income tax treatment comparable to that under federal law.

EFFECTIVE/OPERATIVE DATE

This bill contains an urgency clause. As a result, the provisions of the bill would be effective immediately upon enactment. The provisions of the bill that affect the computation of tax would be operative for taxable years beginning on or after January 1, 2002. All other provisions would be operative on the date of enactment.

POSITION

Support item No 2.

At its March 6, 2002, meeting the Franchise Tax Board voted to sponsor legislation for the suspension of the statute of limitations for financially disabled taxpayers as contained in this bill.

REVENUE TABLE

Estimated Conformity Impact of SB 1805				
As Amended June 17, 2002				
(\$ In Millions)				
Provision	Footnote	2002-03	2003-04	2004-05
Employer-provided Adoption Assistance		Negligible Loss	Negligible Loss	Negligible Loss
Financially Disabled SOL Extension		-\$1	-\$1	Minor Loss
Exclusion of Specified Scholarship Awards	(a)	Negligible Loss	Negligible Loss	Negligible Loss
Installment Method Pledge Rules	(b)	-	-	-
Nonsubstantive Technical Corrections		No Impact	No Impact	No Impact
100 % Shareholder of S Corp may file a Group Return	(c)	Negligible Gain	Negligible Gain	Negligible Gain

Negligible – less than \$250,000 annually

Minor – less than \$500,000 annually

Footnotes:

- (a) Based on federal loss projections of \$1 million per year for this provision, state income tax revenue losses are projected to be insignificant.
- (b) Baseline revenue gains are projected to be \$1 million annually. Estimate was originally included in AB 1122, 2002.

- (c) No specific data is available to determine the revenue effect of allowing one nonresident shareholder to file a composite return. Group return income is taxed at the highest marginal tax rate, cannot include deductions except those necessary to determine each shareholders distributive share, and no credits are allowed other than those directly attributable to the S Corporation. The revenue gain from this election is expected to be negligible (not exceeding \$250,000 annually) beginning in 2002-03.

ANALYSIS

3. Provide Exclusion from Income for Awards Received from the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

FEDERAL LAW

The Internal Revenue Code excludes from gross income amounts received as a qualified scholarship. The tax-free treatment does not extend to scholarship amounts covering regular living expenses, such as room and board. The exclusion for qualified scholarships and tuition reductions does not apply to any amount received that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility.

Prior to the Economic Growth & Tax Relief Act of 2001 (EGTRRA), because the NHSC Scholarship and Armed Forces Scholarship Programs required the recipients to perform services in exchange for the education awards, the awards used to pay higher education expenses were taxable income to the recipient. EGTRRA provided that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships.

STATE LAW

California law was in conformity with federal law, as it relates to the income exclusion for awards received from qualified scholarships, prior to the changes made by EGTRRA.

THIS BILL

This bill would conform California law to the changes made by EGTRRA excluding from income awards received from the NHSC Scholarship Program or the Armed Forces Scholarship Program.

LEGISLATIVE HISTORY

To date, this provision has not been introduced in any other legislation.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York were examined due to similarities to California of those states' tax laws, populations, and business activities. Illinois, Michigan, New York tax laws conform to this federal change. Massachusetts and Minnesota have not conformed to this change. Florida does not impose a personal income tax.

ECONOMIC IMPACT

Revenue Estimate

Based on federal loss projections for this provision (\$1 million per year), state income tax revenue losses are projected to be insignificant.

4. Correct AB 1122's (Stats. 2002, Ch. 35) Inadvertent Failure to Conform to the Modification of the Installment Method Pledge Rules.

The Conformity Act of 2002 (AB 1122) conformed California law to numerous federal changes occurring after January 1, 1998. The Ticket to Work Act (PL 106-170) modified the installment method pledge rules making the rules more restrictive (IRC 453A(d)(4)). AB 1122 inadvertently failed to conform to this federal change. This bill would conform to the pledge rule contained in the Ticket to Work Act.

Prior to the Ticket to Work Act, if a taxpayer on the installment method of accounting "directly" pledged the installment promissory note as collateral for a loan, recognition of the gain from the sale generating the promissory note would be accelerated up to the amount of the pledge. This is done because in effect the taxpayer has received money from the sale of property at the time the loan proceeds are received.

The Ticket to Work Act expanded the pledge rule to installment promissory notes "indirectly" used as collateral for a loan.

ECONOMIC IMPACT

Revenue Estimate

The revenue associated with this provision was included in the analysis for AB 1122. The revenue estimate included in the baseline revenue gain is \$1 million.

5. Technical and Non-Substantive Corrections to AB 1122

This bill would make eight non-substantive technical changes to AB 1122. Five of the corrections affect pension conformity provisions in AB 1122, two of the corrections affect S corporations, and the last technical rennumbers a Revenue and Taxation Code section added by AB 1122.

6. Permit a 100% Shareholder of an S Corporation to File a Group Return

The existing Personal Income Tax Law (PITL) imposes a tax on the income of a non-resident taxpayer that is derived from or attributable to sources within this state. Generally, a non-resident taxpayer will file a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. Form 540NR requires a non-resident to report their income on a world basis (total taxable income or total TI) in one column and California-sourced income in another column. A ratio is determined based on the "tax on total TI" over "total TI". This ratio is applied against California-sourced income to determine the non-resident's tax liability.

The Administration – Franchise and Income Tax Law (AFITL) permits non-resident shareholders of an S corporation with income sourced in this state to elect to file a "540NR group return" (group return). The group return reports the California-sourced pro rata share of the electing shareholders' S corporation income and applies the highest PITL tax rate (currently 9.3%) on the income. Only credits generated by the S corporation may be applied against the group return tax. Exemption credits and net operating losses are not permitted on a group return. A requirement for a shareholder to participate in a group return is that the shareholder cannot have any other California-sourced income (unless being reported on another group return).

A group return can ease the filing burden of non-residents with very little connection to California of a sometimes cumbersome and lengthy Form 540NR. The tax computed on Form 540NR will never be less than the tax computed on a group return. Due to the disallowance of the exemption credits on the group return, the group return will generally result in slightly a bit more tax than a Form 540NR. The tax on a group return can be much greater than a Form 540NR tax. Non-residents who would pay less tax by filing a Form 540NR normally do not elect to participate in a group return and file their individual Form 540NR.

Similar rules to the above apply to partnerships, limited liability companies, and limited liability partnerships.

THIS BILL

This bill would permit a 100% shareholder or a single shareholder of an S corporation to file a group return. Present law uses the term "shareholders," thus, prohibiting a single shareholder from filing a group return. This bill also reiterates the authority of FTB to adjust the income of a nonresident included in a group return to reflect income properly.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York were examined due to similarities to California of those states' tax laws, population, and business activity. Illinois, Massachusetts, Minnesota, and New York permit the filing of a group or a composite (similar to a group) return. It could not be ascertained if these states would allow a 100% shareholder or a single shareholder of an S corporation to file a group or composite return.

Florida does not have a personal income tax and Michigan has a "single business tax." Consequently, this provision does not apply to these two states.

ECONOMIC IMPACT

Because there is little difference between the amount of tax computed on a group return compared to the sum of the tax computed on all the individual Form 540NR returns, the revenue effect associated with this provision is a negligible gain.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

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